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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE PUBLIC SERVICE COMMISSION FOR THE STATE OF NEW YORK, RESPONDENT

OPINIONS BELOW

The initial opinion of the court of appeals (Pet. App. 1-39)[1] and its opinion on rehearing (Pet. App. 41-53) are reported at 462 F. 2d 853, 865. The initial opinion (No. 578) of the Federal Power Commission (Pet. App.

[1] "Pet. App." references are to the appendices to the petition in No. 72-486.

57-66) and its opinion on rehearing (No. 578-A; Pet App. 67-71) are reported at 43 FPC 824 and 44 FPC 140.

JURISDICTION

The judgment of the court of appeals was entered on February 18, 1972 (Pet. App. 55-56), and the Commission's petition for rehearing was denied on May 11, 1972 (Pet. App. 41-53). On August 4, 1972, the Chief Justice extended the time for filing petitions for writs of certiorari to September 23, 1972. The petitions were filed on September 22, 1972. On December 6, 1972, the Court granted both petitions and consolidated the cases. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that Section 441(a) of the Tax Reform Act of 1969, which both the House and Senate Reports stated was intended in general to "freeze" the existing situation regarding methods of depreciation by regulated utilities, precluded the pipelines from increasing their rates by switching from a "flow through" to a "normalized" method of treating their use of liberalized depreciation with respect to their pre-1970 and non-expansion property which was expressly excluded from a 180 day election period provided for seeking agency approval of such changes in pipeline operation.

2. If the Tax Reform Act of 1969 did not restrict a pipeline's authority to seek permission from the Federal Power Commission to increase its rates by shifting from flow through to normalization treatment with respect to

its pre-1970 property, whether the Commission's approval of Texas Gas' shift here was justified under the standards of the Natural Gas Act and the factual record upon which the Commission could ground its decision.

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 626, 26 U.S.C. 167(*l*), is set forth as an appendix to the brief for the petitioner, Federal Power Commission.

STATEMENT

The present case involves a successful effort by Texas Gas Transmission Corporation (Texas Gas) to increase its rates by approximately $4,400,000, over and beyond those approved by the Federal Power Commission to provide the revenues required by its cost-of-service including a reasonable return on its prudent investment. It did so by charging its customers as a tax expense the amount it would have paid in federal income taxes if it had utilized a straight line method of depreciation of its existing facilities when it in fact was utilizing the more rapid "liberalized depreciation" techniques authorized by Section 167 of the Internal Revenue Code. (The actual difference in taxes between utilizing straight line and liberalized depreciation would only have been about half of the $4,400,000 rate increase. But since the Internal Revenue Service treats the additional revenues as taxable income, the Commission authorized Texas Gas to increase its rates by an amount calculated to afford it the use *after taxes* of the entire difference between straight line and liberalized depreciation.)

The Commission Opinion (App. 100-111) grounded its approval of the change in Texas Gas' method of treating its use of liberalized depreciation with respect to its pre-1970 property upon the alleged change in circumstances caused by the enactment of the Tax Reform Act of 1969 and Texas Gas' exercise of the option provided by Section 441(a) thereof under which a pipeline previously utilizing liberalized depreciation with flow through may within a 180-day period after enactment of the Act elect to shift its method of handling the depreciation of its *post-1969 expansion property* either to straight line depreciation or, with the approval of the Commission, to liberalized depreciation with normalization. On review the Court of Appeals for the District of Columbia Circuit unanimously held that Congress, in limiting the election to new expansion property, had intended to freeze the existing situation with respect to a pipeline's use of liberalized depreciation for its pre-1970 property, and Texas Gas accordingly could not be authorized to switch to normalization from flow through for property on which it had been taking liberalized depreciation. In the light of this determination the Court below did not reach the other contentions raised by Memphis Light, Gas and Water Department (Memphis) and the Public Service Commission for the State of New York (New York) in their petitions for review of the Commission's order.

Background

Texas Gas is a major interstate pipeline providing service from the Gulf of Mexico to Ohio. It was originally certificated by the Federal Power Commission to construct and operate its system in 1949, *Texas Gas*

Transmission Corp., 8 FPC 191. During the initial years of its operation it was authorized to depreciate its plant for both book and tax purposes according to a so-called "straight line" method of depreciation under which the rate at which individual units of property are depreciated remains constant over the assets' life. Pursuant to standard regulatory precepts Texas Gas was authorized to include in its cost-of-service expense items covering both the annual depreciation charge and the cost of the federal income taxes which would be due on the taxable net income which would be produced at rates just covering its cost-of-service, including a fair rate of return on its invested capital. Such taxes, in turn, were calculated on a basis which, *inter alia*, permitted the pipeline to deduct its depreciation expenses.

In 1954 Congress adopted Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51. This section added a permanent feature to the federal tax laws,[2] under which qualifying companies, including natural gas pipelines subject to the regulatory authority of the Federal Power Commission were authorized in calculating their taxable income to utilize any one of several methods of accelerated depreciation under which the rate of depreciation on particular items of property is lower in the earlier years than it would be under the straight line method, but higher during the later years of its operation.

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[2]Section 167 of the Code, *supra*, is to be contrasted with Section 168, 26 U.S.C. 168, originally adopted as Section 218 of the Revenue Act of 1950, as an emergency measure to encourage defense plant expansion during the Korean War, under which certain specified types of essential facilities were for a limited time certificated as eligible for accelerated amortization for tax purposes.

We discuss in some detail in the body of the Argument (pp. 32-35) the history of commission and judicial action subsequent to the enactment of Section 167. After the Commission decided in *Amere Gas Utilities*, 15 FPC 760, that pipelines could normalize the use of liberalized depreciation in their accounts—*i.e.*, charge as a tax expense the higher amount the company would have paid if it had been utilizing straight line instead of liberalized depreciation—Texas Gas in 1955 began utilizing liberalized depreciation with normalization. The result was the gradual but steady build up of a fund in Account No. 282 which by the end of 1969 had reached the amount of $12,993,064.

Initally, Texas Gas was permitted to earn a full return on fund; after the commission's decision in *Northern Natural Gas Co.*, 25 FPC 431, it earned 1-½% on the accumulated fund. However, in 1966, after the Commission in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, concluded that for growing or stable pipelines the use of liberalized depreciation involved a tax savings which should be "flown through" to the pipeline's customers, Texas Gas was required to flow through the benefits of its use of liberalized depreciation. Texas Gas, however, exercised the option provided to all pipelines in *Alabama-Tennessee* of maintaining intact the funds already accumulated in Account No. 282 for use in the future should, contrary to the Commission's predictions, the use of liberalized depreciation cease to involve tax savings.

The Proceeding Before the Commission

On June 27, 1969 Texas Gas filed with the Commission a proposed change in its rates and charges which would have increased its rates by an estimated

$36,813,407 annually (App. 57). Among the reasons given by Texas Gas for this proposed increase was "the proposed discontinuance of the use of liberalized depreciation and the reversion to a straight line method of tax depreciation" (App. 53). On August 11, 1969 the Commission suspended the effectiveness of the rate filing until January 12,1970 and set the matter for hearing (App. 64-70), indicating in its order that certain issues might be appropriate for early hearing and resolution, and authorizing the Examiner to phase the hearing so that such issues could be promptly disposed of. Pursuant to this directive the Examiner directed that the hearing be held in stages with "Phase 1 to cover the issues with respect to rate of return and principles applicable to the use of straight line versus accelerated depreciation" (App. 82). Hearing on these two issues was held on December 9, 1969 (App. 84). On this latter date the staff counsel, with the concurrence of all parties in attendance, moved that the intermediate decision of the Examiner in Phase I be omitted and the record transferred to the Commission for its immediate decision on the two issues on which testimony had been taken (App. 81). This motion was granted by the Commission on December 23, 1969 (App. 82).

Throughout this entire period Texas Gas did not suggest that, depending upon the outcome of the tax bill then pending in Congress, it might seek to modify its position to seek to remain on liberalized depreciation but utilize normalization for either its existing or future facilities. Nor did it so indicate in its brief on Phase I of the case filed with the Commission on January 16,1970, over two weeks after the Tax Reform Act of 1969 was approved by the President. Instead it argued that the passage of the Act required approval of its proposed

switch to straight line depreciation for its existing plant since its proposed exercise of its election under the 180-day option provision of the Act to use normalization on its future plant allegedly would eliminate the tax savings effect of continuing to use liberalized depreciation (App. 88).

On May 4, 1970, Texas Gas filed a motion with the Commission—which had not yet acted on the Phase I issues—asking for expedited decision on the limited issue of tax depreciation (App. 90-94). It gave as a reason for this request the fact that the 180-day option provided by the Tax Reform Act for switches from liberalized depreciation with flow through with respect to new post-1969 property would expire on June 29, 1970 and that "before making this election, however, Texas Gas needs assurance from the Commission that it will be permitted to discontinue the use of liberalized depreciation for rate making purposes with respect to existing plant" (App. 92). However, on May 22,1972 (after the Commission had issued its Order 404, discussed below) counsel for Texas Gas wrote a letter to the Commission, in purported response to a "question raised by a customer-intervenor" in which, for the first time Texas Gas stated that "if the Commission permits Texas Gas to use normalization for rate making purposes" it proposed to continue the utilization of liberalized depreciation with normalization with respect to its "pre-1970 public utility property" as well as on the new property which was the subject of its proposed election (App. 97-98).

On May 15, 1970 the Commission issued, without notice or hearing, a Statement of Policy in Order 404, 43

FPC 740,[3] in which it determined that it was in the public interest to allow natural gas companies exercising the 180-day election provided by the Tax Reform Act of 1969 with respect to post-1969 expansion property, to shift from the use of liberalized depreciation with flow through for such property to liberalized depreciation with normalization, for purposes of both accounting and rate making.[4] And on June 3, 1970 the Commission issued its Opinion 578 here under review (App. 103-111), which authorized Texas Gas to utilize liberalized depreciation with normalization for accounting and rate making purposes "with respect to its property other than that subject to election under Section 167[*l*](1)(4)(A) of the Internal Revenue Code as amended by Section 441 of the Tax Reform Act of 1969" (App. 111). It did so primarily on the grounds that Texas Gas' exercise of its statutory election to normalize with respect to post-1969 property would mean that its continued use of liberalized depreciation on its pre-1970 property, and non-expansion additions or replacements thereof, would cease to involve a tax savings and therefore its previous basis for requiring flow through with respect to such property had ceased to exist (see, *e.g.*, App. 108-109).

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[3] *Calculation of Taxes for Property of Public Utilities, Licenses and Natural Gas Pipeline Companies Constructed or Acquired After January 1, 1970*, 43 FPC 740 (hereinafter "Order 404").

[4] This action of the Commission was the subject of appeals by Memphis and the Tennessee Valley Municipal Gas Association, and the court below affirmed the Commission in the same opinion here under review. A petition for certiorari of this aspect of the court of appeals decision was denied by this court on October 16, 1972. *Memphis Light, Gas and Water Division v. Federal Power Commission, et al.*, No. 72-96.

Nine days after the issuance of Opinion 578, on June 12, 1970, Texas Gas filed a motion for approval of a "settlement" of all other phases of its rate increase proceeding, including the rate-of-return issues which had been tried as part of Phase I of the case (App. 112-117). New York, which was not a party to the so-called settlement agreement, objected to its approval (App. 123-124). New York pointed out, *inter alia*, that the Commission's approval of the use of liberalized depreciation with normalization of Texas Gas' existing plant in Opinion 578 had been predicated in part upon the fact that this action would improve the company's before tax coverage of interest and its cash flow problem, and that it was inappropriate to consider the 8% rate-of-return allowance for Texas Gas which underlay the settlement without consideration of the additional $4,400,000 tax allowance it had just authorized in Opinion 578, since such an allowance "bears many of the attributes of return" (App. 124). The Commission, however, approved the settlement by Order of July 17, 1970 (App. 137-145), rejecting New York's contentions on grounds that the additional $4,400,000 tax allowance for Texas Gas did not represent return since the funds accumulated in Account 282 representing the difference between the taxes it actually paid and those it booked for rate purposes, would not be available for transfer to surplus or payout in dividends, and would be deducted from rate base in rate cases (App. 144).

New York (App. 125-129) together with Memphis (App. 118-122) and the Philadelphia Gas Works Division of the UGI Corporation (App. 133-136) petitioned for rehearing of Opinion 578, pursuant to the provisions of Section 19(a) of the Natural Gas Act, 15 U.S.C. §717(r

On July 21, 1970 the Commission issued its Opinion No. 578-A (App. 145-149) which denied the petitions in all respects.

The Proceedings in the Court Below

Petitions for Review of Opinion 578 were filed in the Court of Appeals for the District of Columbia Circuit by both Memphis and New York. On February 18,1972 the Court (Judges Fahy, Robinson and Wilkey) reversed the Commission. In an opinion by Judge Wilkey the Court concluded that, consistent with its intent to in general freeze the existing situation, the Congress limited the election provided to regulated utilities using liberalized depreciation with flow through to shift to either straight line depreciation or liberalized depreciation with normalization to expansion property acquired after January 1, 1970, and that this action precluded any shift from flow through to normalization on the utility's existing property (Pet. App. A, pp. 17-39). In view of this determination the court did not reach the other arguments advanced by Memphis and New York as to the validity of the Commission's action. On rehearing, the court reaffirmed its decision in a detailed supplemental opinion (Pet. App. B, pp. 41-53).

SUMMARY OF ARGUMENT

The Federal Power Commission in this case held that the exercise of the limited option, which Section 441 of the Tax Reform Act of 1969 provided to utilities to shift from a flow through to normalized manner of treating their use of liberalized depreciation for new expansion

property put into service after 1969, justified Texas Gas to similarly shift from flow through to normalization with respect to all of its existing property. The result of the Commission's action was directly the opposite of the Congressional intent to generally freeze the existing situation with respect to utility methods of tax depreciation so as to prevent either widespread revenue losses to the treasury or immediate rapid price increases to utility customers. The court below correctly held that such action to abandon flow through accounting with respect to pre-1970 property was expressly precluded by Congress in the Tax Reform Act. But, even if this were not the case, the Commission's conclusion that the operation of the Tax Reform Act served to convert the use of liberalized depreciation by Texas Gas from a tax savings to a tax deferral, and that therefore it was appropriate to permit it to charge as a tax expense the higher amount it would have paid had it utilized straight line depreciation, is clearly lacking in merit.

1. The court of appeals correctly concluded that the Senate version of the tax bill provided a procedure under which utilities using liberalized depreciation with flow through would have 180 days to elect to seek to change their mode of depreciation on all of their property to straight line or normalization, and that the subsequent limitation of this election in conference to new expansion property had the effect of freezing the *status quo* with respect to a utility's old or non-expansion property. The petitioners' arguments that the election introduced into the bill by the Senate was intended to provide an additional avenue of relief to the utilities is inconsistent with the language of the Senate bill and unsupported by any statement of such an intent in the Senate report. Moreover, it necessarily depends upon the assumption

that the Congress adopted an "additional" avenue for permitting a shift from flow through to normalization which was more restrictive than the allegedly independent and continuing path for achieving the same objective, and that its subsequent limitation of the election was without significance.

The court of appeals construction of the Tax Reform Act is far more in keeping with the underlying Congressional intent in adopting Section 441 than the alternate construction of the petitioners. The main objective of Congress was to prevent any revenue losses to the Treasury by precluding utility or agency action to shift depreciation practices from straight line to liberalized depreciation or from normalization to flow through. Congress rejected proposed methods of achieving its revenue objectives which would require either widespread changes in existing utility practices or result in significant major rate increases during a period of inflation, opting instead for a system which both the Senate and House Committees stated would "in general freeze the current situation regarding methods of depreciation. . . ." Clearly action by the conference to limit the right of utilities to seek to abandon flow through to new expansion property, which would allow for gradual increase in tax revenues as eligible new plant comes into service, but preclude massive immediate rate increases like those approved here, was a move directly in line with these objectives.

2. While it has long been held that federal income taxes are an expense which can properly be recovered as part of a regulated utility's cost-of-service, the courts have consistently held that tax savings provided by the Congress to a utility must be reflected in the computation of such tax allowances, at least where Congress has

not expressly directed to the contrary. This is no less true with respect to a pipeline's use of liberalized depreciation. Though a number of the early court decisions refused to interfere with the Commission's original determination that pipelines could normalize the use of liberalized depreciation for both accounting and tax purposes, they did so because of their acceptance of the Commission conclusion that the use of liberalized depreciation resulted in a tax deferral for the pipeline rather than a tax savings. When it was recognized that a utility maintaining a growing or stable plant will secure a permanent tax savings from its use of liberalized depreciation, the Commission, with the approval of the courts, reverted to the controlling "actual taxes" doctrine.

The Commission opinions here do not suggest that Texas Gas will cease to maintain a growing or stable gas plant in the foreseeable future; on the contrary, the Commission concludes that its overall growth will continue. However, the Commission held that since Texas Gas will now be authorized to normalize with respect to its new expansion property, the lower taxes it pays on such property will not be available to offset the higher taxes it might have to pay on its existing property, and that therefore its continuing use of liberalized depreciation on such property will cease to involve a tax savings. This arbitrary bifurcation of the pipeline's facilities is nothing but a reversion to the discredited concept of evaluating the effect of liberalized depreciation on a unit by unit (or group of units) basis when in fact the pipeline's tax obligations will continue to be determined on a company wide basis.

While the additional amounts in Account 282 resulting from the use of normalization of Texas Gas' new expansion property, like the substantial existing amounts

in the reserve account which built up during the early period when Texas Gas was authorized to normalize its use of liberalized depreciation, will not be necessary to pay increased taxes as long as the system as a whole continues to grow or remain stable, they would be available in the unlikely event this situation were to cease to exist. Moreover, even it it were proper to consider the old plant in isolation, there is demonstrably no basis for the Commission's conclusion that future tax payers might have to pay higher tax allowances if Texas Gas continues to flow through the present tax benefits with respect to such property. Nor is there any basis in this record for concluding that Texas Gas should be permitted to charge a fictitious tax expense in order to improve its before taxes interest coverage or to increase its cash flow.

ARGUMENT

I.

THE COMMISSION LACKS AUTHORITY TO PERMIT PIPELINES WHICH HAD BEEN UTILIZING LIBERALIZED DEPRECIATION WITH FLOW THROUGH TO SWITCH TO NORMALIZATION WITH RESPECT TO THEIR EXISTING PROPERTY

The court of appeals in the decision here under review, found it unnecessary to consider the various contentions raised by Memphis and New York below as to why they felt that the Commission's action approving Texas Gas' effort to increase its rates by shifting to a normalized treatment of the liberalized depreciation it continues to take on its existing plant was invalid in its own terms. For the court concluded that Congress in the Tax Reform Act of 1969, in aid of its general objective of freezing the existing situation with respect to utility depreciation

practices, had deliberately precluded any such shifts. This result, the court of appeals concluded, had come about as a result of action by the Senate to specify that moves by regulated companies presently utilizing liberalized depreciation with flow through either to straight line depreciation or normalization would have to be accomplished within a 180-day period, and the subsequent limitation of this election to any utility's new expansion property.

We show in this part of our brief that the lower court's interpretation of the effect of the Tax Reform Act of 1973 was correct as a matter of statutory construction and is far more consistent with the dual objectives of the Congress of preventing revenue losses to the treasury without causing any substantial rate increases than that which would necessarily result from acceptance of the contrary views pressed by the petitioners.

A. The Court of Appeals Correctly Concluded That the Restriction of the Election To Shift From Flow Through to New Expansion Property Eliminated the Commission's Discretion To Authorize Such Shift on Old Existing Property

The court of appeals concluded (Pet. App. 31-33) that, while the House bill authorized a utility which had been taking liberalized depreciation and flowing through the savings to its customers, to shift, with the permission of the Commission, to either straight line depreciation or liberalized depreciation with normalization, the Senate had limited the utility's option to seek such changes in its methods of operation to an 180-day election period. Since this election admittedly was curtailed in conference so as to apply only to post-1970 expansion property, the court below reasoned that a utility's right to switch from

flow through to normalization was in turn limited to such new expansion property. As to pre-1970 property or new property which did not increase "the productive or operational capacity of the company," the situation was "frozen" and no shifts from flow through permitted.

The Commission and Texas Gas, in taking issue with this position, do not dispute either the power of Congress in a tax bill to restrict the authority of the Commission and other regulatory agencies in the exercise of their rate making authority[5] or the fact that Congress in other respects restricted agency regulatory action in Section 441 of the Tax Reform Act of 1969. But they argue vigorously that the 180-day election feature introduced into the bill by the Senate was an "additional" form of relief provided to the utilities, separate and distinct from their preexisting right under the House bill to switch from flow through to straight line, or normalization with the permission of the Commission. They argue that the election's subsequent restriction to new expansion property did not affect the separate and continuing right of the utility to seek permission from the Commission to switch to straight line or normalization on its old or non-expansion property.

There is nothing in the language of either the Senate bill or subsequent Act which supports the treatment of

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[5]See, *e.g.*, Section 203(e) of the Revenue Act of 1964, 78 Stat. 35, which with respect to the Investment Tax Credit stated that "Congress does not intend that any agency or instrumentality of the United States . . . shall, without the consent of the taxpayer, use [the credit] to reduce such taxpayer's federal income taxes for the purpose of establishing the cost of service of the taxpayer or to accomplish a similar result by any other method."

the election as a separate additional remedy.[6] Consequently, in the absence of any clear statements in the Senate or Conference reports that this was Congress' intent, the petitioners have of necessity had to fall back upon language in the reports and the Joint Committee's General Explanation of the Act which is at best oblique and as the lower court's opinion points out (Pet. App. pp. 35, 49) contradicted by other statements in the same reports. But we do not believe that it is necessary for this court to involve itself in the at best unsatisfactory effort to glean significance from a syntactical analysis of the language of congressional reports. For acceptance of the contentions that the election was separate and distinct from the other provisions of the section, which allegedly

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[6]The most the Commission can glean from the language of Section 441 of the Tax Reform Act is that paragraph 1B of the new section 167(*l*) states that in the case of any pre-1970 public utility property the taxpayer *may* use the applicable 1968 method for such property (see Pet. App. 73). The use of the word "may," the Commission indicates (Br. 20), "suggests" that Congress contemplated such utilities might seek permission to abandon flow through where this was the method they had been following in 1968. But such a position not only requires the assumption that Congress relied upon a possible grammatical construction as the sole signpost of its intent, but is, as the Commission recognizes (Br. 21, n. 10), inconsistent with other language in the section. For no such language appears in paragraph (2)(c) of the governing section post-1969 property. Thus if it has the significance the Commission urges, post-1969 property not subject to the election provided by paragraph 4(A), *i.e.*, post-1969 property which does not increase the productive or operational capacity of the pipeline or represents replacement of existing capacity, would not be eligible for normalization if flow through had previously been taken on similar property. Faced with this inconsistency, the Commission merely indicates that there is no reason to believe the two vintages of property were intended to be treated differently (*ibid.*).

provided utilities like Texas Gas with a continuing power to switch from flow through to normalization with the consent of the Commission, would result in a situation in which the election as initially proposed by the Senate would be largely redundant and the Conference's later action in restricting its scope would constitute an exercise in futility.

One would think that petitioners' attempts to show that the Senate bill "added" a separate election provision to the remedies already available to the utilities would start with the language of the Senate bill. This is particularly so in the absence of any clear statement in the Senate Report of intent to add a new remedy. But the reason for the absence of any such reference in petitioners' briefs becomes clear when the relevant text of the Senate bill, attached hereto as Appendix A, is examined.

As paragraph (4) of Section 441 of the Senate bill expressly states (Appendix A, pp. 5a-6a), the 180-day election was included "for purposes of determining whether or not a taxpayer used a flow through method of accounting for its July 1969 accounting period with respect to any property—(A) *In applying paragraph (1)(B) or (2)(C)* for taxable years beginning after December 31, 1970 . . ." (emphasis added). If the utility "so elected" within the 180-day period prescribed he was to be deemed not to have used liberalized depreciation with flow through under either of the specified provisions. In short, as the heading of paragraph 4 of the Senate bill (and of the Act as it emerged from the Conference) indicates, the election was and is part of a "special rule" governing *how* and *when* the utility's right to switch from liberalized depreciation with flow through to straight line

or normalization with respect to both old and new property was to be exercised, rather than any additional form of relief.

Moreover, as Texas Gas recognizes (Br., p. 23), the argument that the Senate election added a separate avenue of relief for utilities wishing to switch from flow through to normalized accounting and rate treatment, which was independent of their allegedly continuing right to accomplish the same result under the "third general rule," necessarily implies that the Senate superimposed upon a continuing right of the utility to switch from flow through to normalization, at any time the Commission permits, a special right to do the same thing during a limited period, which could also be implemented only with the permission of the Commission. Texas Gas would avoid this redundancy by pointing to the fact that the Senate's election also gave utilities a right, during the 180-day period, to switch from flow through to straight line depreciation. This option, unlike the one where the proposed shift was to normalization, could be availed of during the election period whether or not the Commission approved, whereas under the "general rule" Commission approval was allegedly required to switch from flow through to straight line as well as to normalization. Any such difference between the general rule and the election with respect to a move to straight line depreciation would, of course, not explain why the Congress would have "added" a provision authorizing a switch to normalization which was more restrictive than the one assertedly being supplemented. On the contrary it would suggest that the election was only available with respect to a move to straight line depreciation. But the Senate Report on the bill (S. Rep. No. 91-552, 91st Cong., 1st Sess. pp. 173-174) expressly stated that the election it was

providing applied to shift to both straight line and normalization. Moreover, any other construction would be contrary to the Commission's conclusion in Order 404, which was affirmed by the court below in the same opinion here under review,[7] that the election was applicable to a shift to normalization, if the Commission approved the move.

Texas Gas attempts to surmount these difficulties by suggesting (Br. p. 25) that Congress provided an "additional" election which gave the utility power to switch from flow through to straight line, with or without the permission of the Commission, and to normalization if, but only if, it secured such permission, as part of a conscious design "to put pressure upon the regulatory agencies when confronted with the problem during that [180 day] period more freely to grant to such a company permission to change to normalization." This may be an accurate reflection of how the tax law changes were utilized by Texas Gas. But it not only requires crediting the Congress with a degree of disingenuity for which there is no support in the legislative history of the Tax Reform Act, but requires an assumption that the drafters of the Act, who were worried about possible losses of revenue, deliberately "put pressure" upon the regulatory agencies to move from flow through in the manner which would result in the least additional tax revenues. If this in fact had been Congress' intent it could, of course, have made

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[7]This portion of the lower court's opinion involved an appeal by Memphis and the Tennessee Valley Municipal Gas Association (Case Nos. 24,518 and 24,602 in the court below) in which New York did not participate. A petition for certiorari by Memphis from this part of the lower court's opinion was denied by this court on October 16, 1972. *Memphis Light, Gas and Water Division v. Federal Power Commission, et al.*, No. 72-96.

the election available only to a shift from flow through to normalization, or at least have given the utility the unlimited option to do so, just as it did with respect to shifts to straight line.

Finally the position of both the Commission and Texas Gas leaves the action of the Conference in deliberately restricting the election to new expansion property devoid of all meaning. Of course if the election, as originally drafted by the Senate, applied only to a shift from flow through to straight line depreciation, its subsequent restriction would not affect any continuing rights of the Commission to authorize a move from flow through to normalization. But this is one construction of the Act which no one has attempted to advance; as we have seen *supra* at p. 19, it is clearly precluded by the language of the Senate amendment which refers back generally to paragraphs (1)(B) and (2)(C) of the section. Accordingly what both the Commission and Texas Gas are necessarily contending is that the conferees' deliberate restriction of the election to new, expansion property was of no effect with respect to a shift to normalization since the alleged "general" right of a utility to make the same shift survived the limitation to new expansion property of the 180-day election to do the same thing. It goes without saying that such a construction of congressional action is not favored.

B. The Lower Court's Construction of the Tax Reform Act's Amendment of Section 167 of the Internal Revenue Code Is Consistent With Congressional Intent

The "problem" which led to the amendment of Section 167 of the Internal Revenue Code in the Tax Reform Act of 1969 is well summarized at pp. 131-132 of the House Report on the bill. (H. Rep. No. 91-413, 91st Cong., 1st Sess.) See also S. Rep. No. 91-552, 91st Cong., 1st Sess., pp. 175-176; General Explanation of the Tax Reform Act of 1969, prepared by the Joint Committee on Internal Revenue Taxation, pp. 150-151 (set out in the brief in this case filed by Memphis).

Congress had already reduced federal revenues by making available to gas pipelines and other regulated utilities the option to use various methods of liberalized depreciation in calculating their federal income tax, an action which, where the company enjoys an expanding or stable plant, results in a permanent tax savings. The revenue loss had been enhanced as more and more state and local regulatory bodies, in recognition of the tax savings effect of the use of liberalized depreciation, concluded that there was no basis for permitting the companies to include a fictitious tax expense in their cost-of-service calculations by "normalizing" the amount charged to federal income taxes, *i.e.*, by claiming as an expense the higher amount they would have owed had they instead taken straight line depreciation. Consequently, these regulatory bodies (which included the Public Service Commission for the State of New York as well as, eventually, the Federal Power Commission) limited the regulated company's tax allowance to its actual tax liability, and thus flowed through the tax savings to

consumers. Since the inability to inflate their rates by the non-existent tax expense *pro tanto* reduced the regulated companies' net income, the treasury "lost" the additional tax revenues they would have received from taxing such additional income.[8] As the House Report notes as of 1969 about half the regulatory agencies required utilities subject to their authority to flow through the resulting reduction in federal taxes to their customers.

While Congress was interested in preventing any more regulatory agencies from requiring regulated companies voluntarily utilizing liberalized depreciation to flow through the benefits to their customers, by far the most serious threat to treasury revenues was the possibility that additional regulatory bodies would follow the lead of the California Public Service Commission and *impute* the use of liberalized depreciation with flow through to companies, like the Bell System, which up to that time had always utilized straight line depreciation.[9] It was reported to the House and Senate Committees that if this decision (which was then on appeal) was affirmed, and particularly if the Federal Communications Commission was to go through with its announced plan of considering adoption of a similar policy for all of the Bell System's

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[8]The Congressional reports talk in terms of the loss to the treasury in tax revenues from utility use of liberalized depreciation being doubled where the utilities rather than their customers secure the benefit of the tax reduction. See, *e.g.*, House Rep. p. 134. This is, of course, only true if one focuses upon the reduction in utility income and ignores the resulting increase in business customer income which is also subject to federal tax.

[9]*Pacific Telephone and Telegraph Co.*, 62 Cal. P.U.C. 53, *affirmed, City and County of San Francisco v. Public Utilities Commission*, 490 P.2d 798 (1971).

interestate rates,[10] the huge Bell System would of necessity be required to switch to the use of liberalized depreciation. See, *e.g.*, Hearings before the House Committee on Ways and Means, 91st Cong., 1st Sess., on the Subject of Tax Reform, pp. 38, 58-98. And to these immense tax revenue losses might have been added those from other utilities than using straight line depreciation but faced with the threat that their regulatory agency would impute to them the use of liberalized depreciation on grounds it was their duty to minimize costs.[11]

The Federal Power Commission's preferred response to this problem was to withdraw from the pipelines and other utilities the right to use other than straight line depreciation, see House Report, p. 132. This remedy, which would have been most favorable from the standpoint of the treasury, was, however, rejected by the Congress on grounds that:

> "In too many cases this would place regulated utilities at an unfair competitive advantage, both in terms of the sales of their products or services and their attractiveness to equity investors. Also this

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[10] See *American Telephone and Telegraph Co. and the Associated Bell System Companies, Charges for Interstate and Foreign Communications Service*, 9 FCC 2d 30, 84.

[11] The Federal Power Commission had never imputed the use of liberalized depreciation to a company which had consistently used straight line. But in *Midwestern Gas Transmission Co.*, 36 FPC 61 (1966), *affirmed, Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444 (C.A. 7), *certiorari denied*, 392 U.S. 928, the Commission had imputed the use of liberalized depreciation to a pipeline which had attempted to shift to straight line depreciation after the Commission held liberalized depreciation would be flown through.

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would result in prompt, substantial, and widespread utility rate increases.[12]

"Accordingly your Committee has determined *in general to 'freeze' the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more healthy utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return." (House Report, No. 91-413, *supra*, p. 132-133, see also Senate Rep. No. 91-552, *supra*, p. 172.

The principal threats to the treasury were taken care of by the Congress by absolute prohibitions upon any regulated company not already on liberalized depreciation with flow through moving thereto, and upon any regulatory imputation of liberalized depreciation with

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[12] The Texas Gas brief (pp. 61-62) notes that this language about rate increases, and similar language in the Summary of the Bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation and the Committee on Finance at p. 73, does not appear in the Senate or Conference Reports. It suggests that this indicates that later versions of the bill were recognized as providing for greater and more immediate rate increases.

In view of the fact that the Senate Report repeats, almost verbatim, the "freeze" language from the House Report, it would appear that the absence therein of a reference to limitation of rate increases may well represent its efforts to paraphrase in one paragraph the first four paragraphs in the House Report as to "general reasons for change." But if one is to join Texas Gas in its excursion into psychohistory, it can be as easily postulated that the language was left out of the Senate Report because its *substitute* of a 180-day election period, and the new election's absolute right for a utility to shift to straight line depreciation, led it to believe that the rate increases permitted (*prior* to scaling down the election in conference) would result in more immediate and more substantial rate increases.

flow through to companies choosing to remain on straight line depreciation. (This latter objective was achieved by prohibiting a company, not already on liberalized depreciation with flow through, from utilizing any of the liberalized methods of depreciation unless the regulatory agency prescribed normalization.) And finally any shift from straight line depreciation to liberalized depreciation on pre-1970 property was prohibited.

All of these provisions to preclude moves to flow through were in the House version, and the Senate and Conference modifications did not affect them. The issue is instead the extent to which the Senate's adoption of the 180-day election period for moves *to* straight line and normalization, and the Conference Committee's subsequent reduction of its scope, limited the range of the rate increasing shifts from the *status quo* which the House bill had permitted.

In this context the court of appeals' construction of the bill's developments in the Senate and Conference as precluding shifts from flow through except for new expansion property are, we submit, far more in keeping with the Congress' continuing determination "in general to 'freeze' the current situation regarding methods of depreciation" (House Report, p. 133, Senate Report, p. 172) than the construction, necessarily adopted by the Commission and Texas Gas. For they are required to argue that the Senate, through professing to adhere to the "freeze," provided an "additional" way for utilities to raise their rates, and that the conference's later limitation of this election, left unimpaired the avenue originally provided by the House bill.

The Commission brief (p. 38) recognizes that one of the major purposes of the "freeze" was "to guard against

'prompt, substantial and widespread' rate increases." It says, however, that this was to be accomplished by limiting the changes in "methods of depreciation" which would cause such increases to those "particular situations [where] the abandonment of flow through by a utility would be in the public interest." (See FPC Br. p. 29.) This statement is of course completely inconsistent with the Commission's position in Opinion No. 568 that it was Texas Gas' exercise of the election to shift to normalization for its new property which required it to approve the proposed switch to normalization on Texas Gas' old property as well. (See Part II of this brief.) Moreover, it certainly does not detract from the validity of the lower court's conclusion (Pet. App., pp. 46-47) that the Senate bill increased the likelihood of substantial immediate rate increases by requiring all shifts to be made within 180 days and making possible shifts to straight line depreciation without any agency approval, and that the conference compromise was to limit all such changes to new expansion property. For this interpretation, unlike the construction propounded by the Commission and Texas Gas, would allow for a gradual shift to straight line or normalization with respect to new expansion facilities—[13] and to this extent increase tax revenues[13]—without

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[13] It is this gradual shift, with respect to new property, rather than any precipitate changeover on existing property, which, we suggest, was contemplated by the Congress when it estimated that tax revenues would increase by 60 million in 1970, 260 million in 1974 and 310 million in 1979. (House Report, p. 134.) And the Senate Report's statement (p. 176) that these sums did not take into account the uncertain effect of the election (then not restricted to new expansion property) could well reflect its recognition that forcing a choice within 180 days (plus freeing shifts to straight line from any agency restraint) would affect the timing and extent of such rate increases.

adding immediately to the inflationary pressures, of which the Congress was all too well aware, by the immediate and substantial rate increases which would result from affirmance of the Commission's action here.

II.

THE COMMISSION'S ACTION PERMITTING TEXAS GAS TO CHARGE ITS CUSTOMERS FOR TAXES IT HAD NOT PAID WAS INVALID, EVEN IF IT WAS NOT PRECLUDED BY THE TAX REFORM ACT OF 1969.

Since the Court below held that Congress in the Tax Reform Act of 1969, had prohibited any pipeline taking liberalized depreciation with flow through from shifting to normalization except for new expansion property, it did not reach the several other contentions of the Memphis and New York as to why the Commission's action in Opinion 578 was invalid. Like petitioners we do not believe that a remand to the Court of Appeals is necessary to resolve these issues. But, even assuming the Commission retained the authority in appropriate circumstances to permit a pipeline to include an allowance for federal income taxes in its cost-of-service based on the taxes it would have paid if it had taken straight line depreciation, when in fact it paid substantially less due to its utilization of liberalized depreciation, it is clear that the Commission's decision to permit the Texas Gas rate increase was invalid.

1. The Commission brief starts from the assumption that the Commission has almost unlimited discretion in how it fixes rates and, in particular, in how it treats various tax savings in fixing such rates. But the

"end result" shiboleth of the 1943 Hope case,[14] is not the limit of judicial expression as to the proper manner in which an agency can fix rates. With special application to charges for federal taxes it has been repeatedly held that a regulated company is, in addition to a return of its operating expenses and a return on its prudently invested rate base, entitled to recover in rates enough to pay its federal and state taxes. See, *e.g., City of Chicago v. Federal Power Commission*, 385 F.2d 629, 633 (C.A.D.C.), *certiorari denied, sub nom. Public Service Commission of Wisconsin v. Federal Power Commission*, 390 U.S. 945. But as this Court expressly held in *Federal Power Commission v. United Gas Pipe Line Co.*, 386 U.S. 237, 244:

> "... when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the rate making principle that limits cost of service to expenses actually incurred. Nothing in Colorado Interstate[15] or Panhandle[16] forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary both cases support the power *and the duty* of the Commission to limit cost of service to real expenses. (Footnote omitted, emphasis added.)[17]

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[14] *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602.

[15] *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581.

[16] *Panhandle Eastern Pipe Line Co. v. Federal Power Commission*, 324 U.S. 821.

[17] The Court in *United* also characterized as "untenable" a United position on the allocation issue involved in that case which

In so holding this Court, as it recognized (386 U.S. at 245, n. 3), was following the earlier precept of Judge Tuttle in *El Paso Natural Gas Co. v. Federal Power Commission*, 281 F.2d 567 (C.A. 5), *certiorari denied, sub nom., California v. Federal Power Commission*, 366 U.S. 912. In *El Paso* the Court rejected the claim that the company was entitled to the benefits of the percentage depletion and intangible well drilling allowances provided to gas producers, holding (281 F.2d at 572-573) that:

> "The requirement that the Commission determine a just and reasonable rate is not modified by reading into the statute an exception to the extent that the prices charged may be sufficient to afford a just and reasonable rate *plus* an amount representing a savings in taxes granted the gas industry . . . .
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> "We think, in short, that there is no statutory authority for the Commission to treat actual savings as taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the

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"would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred" (386 U.S. at 244).

In *United* both the court majority and minority agreed that tax savings property attributable to the regulated company could not form the basis for an additional return to the company. The issue between them was whether, in the context of a consolidated tax return, a profit making regulated company could properly be allocated any of the tax savings which had reduced the effective rate of the system as a whole below the 48% norm.

natural and necessary consequence of rate regulation (emphasis in original).

See also to the same effect *City of Chicago v. Federal Power Commission, supra,* 316 F.2d at 633-634 (C.A. D.C.); *Alabama-Tennessee Natural Gas Co. v. Federal Power Commission,* 359 F.2d 318, 327-328 (C.A. 5), *certiorari denied,* 385 U.S. 847. And as the Court of Appeals made clear in the latter case (*ibid.*) this "traditional regulatory concept" goes back at least as far as this Court's opinion in *Lindheimer v. Illinois Bell Telephone Company,* 292 U.S. 151, 169.

2. While the administrative and judicial history of liberalized depreciation is a checkered one, it does not upon any proper analysis yield to the "anything goes" interpretation advanced by the Commission. On the contrary when the courts have approved deviation from the actual taxes precept it has been either because they were convinced that a factual question was presented for agency expertise as to whether the tax reduction was more likely to be a temporary deferral than a tax savings, or because they felt that Congress had mandated that the tax savings go to the utility's stockholders rather than its rate payers.

The Federal Power Commission's grappling with the problem of how to treat liberalized depreciation got off on the wrong foot in *Amere Gas Utilities Co.,* 15 FPC 760. The Commission had previously ruled that the special provisions of Section 168 of the Internal Revenue Code, authorizing the rapid tax amortization of emergency facilities built to aid the Korean War involved a tax deferral rather than any permanent tax savings and had therefore authorized normalization of the taxes paid. *Treatment of Federal Income Taxes as Affected by*

Accelerated Amortization, 12 FPC 369. It applied the same policy in *Amere* to the provisions authorizing utilities to use liberalized depreciation for tax purposes which Congress added as a permanent feature of the tax law by the adoption of Section 167 of the Code in 1954. Though the Examiner in *Amere* had found that, when the company's operations were considered as a whole, the use of liberalized depreciation produced tax savings rather than a mere tax deferral (15 FPC at 773), he concluded that the Congress had intended that the benefits of the tax reduction go to the owners of the business rather than the shareholders. The Commission, in affirming his decision, in addition concluded that the use of liberalized depreciation would result in a tax deferral rather than tax saving. See 15 FPC at 782. The Commission continued to authorize normalization either on the basis of an assumed Congressional mandate or because, focusing upon the individual units of plant, it construed liberalized depreciation as providing only for a temporary tax deferral, until 1964. See, *e.g.*, *El Paso Natural Gas Co.*, 22 FPC 260, 266-67; *United Fuel Gas Co.*, 23 FPC 127, 512; *Northern Natural Gas Co.*, 25 FPC 431.

In *El Paso Natural Gas Co. v. Federal Power Commission*, *supra*, the Court of Appeals, despite Judge Tuttle's ringing reaffirmation of the actual taxes doctrine as related to the Commission's attempt to give the company the benefit of the depletion allowance and intangible well drilling tax savings, refused to intervene to upset the Commission's approval of the company's normalization of liberalized depreciation. It did so on the grounds of its belief that "in practical effect this [the use of liberalized depreciation] works a tax deferral rather than a tax savings" and that normalization was therefore appropriate to "equalize [higher] tax payments in later years."

281 F.2d 567 at 573-574. Similarly, the Court of Appeals for the Fourth Circuit in *Cities of Lexington, etc. v. Federal Power Commission*, 295 F.2d 109, 111-115, affirmed the Commission's normalized treatment of liberalized depreciation in the *United Fuel Gas* case, *supra*. Though it recognized that there was a dispute as to whether a tax savings or tax deferral was involved, it believed that the resolution of this factual question involved a "problem in a special field which requires the exercise of expert skill that has generally been entrusted by state and federal legislation to administrative regulatory tribunal whose decisions, in the absence of an abuse of discretion, should be followed by the courts" (*id.* at 114). But at other parts of its opinion (195 F.2d at 115-117) it expressed its agreement with Judge Tuttle's conclusion in *El Paso, supra*, that actual tax savings could not be ignored in fixing a regulated company's cost of service stating (195 F.2d at 116):

> "We find nothing in the Natural Gas Act which requires the Commission to ignore the usual principles of cost accounting and set up a fictitious and unreal tax expense on the part of the utility in order to give it the entire benefit of the tax saving statutes and none to the consuming public. The very spirit and purpose of the regulatory provisions of the Natural Gas Act point the other way. *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 610, 612, 64 S.Ct. 281.

See also *Panhandle Eastern Pipeline Co. v. Federal Power Commission*, 316 F.2d 659 (C.A.D.C.), where the Court in affirming the Commission's limitation of the return on the increasing reserve fund established by the use of liberalized depreciation to 1.5%, apparently assumed (316 F.2d at 661, 663 n. 1) that liberalized depreciation involved "tax deferrals rather than tax savings." But the

Court also held that "nothing in the language or legislative history [of Section 167 of the Internal Revenue Code] indicates that Congress considered its regulatory consequences" (316 F.2d at 662).

This was the situation when the Commission in 1962, in the light of the decisions in *El Paso* and *Panhandle*, *supra*, indicating that its hands had not in fact been tied by the Congress in adopting Section 167 of the Internal Revenue Code, initiated a thorough reexamination of the problem. Its conclusion in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, *affirmed*, *Alabama-Tennessee Natural Gas Company v. Federal Power Commission*, 359 F.2d 318 (C.A. 5), *certiorari denied*, 385 U.S. 847, was that Congress in adopting Section 167 had not modified the general rate making objectives of the Natural Gas Act to provide service to gas consumers at "the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest" (see *Atlantic Refining Company v. Public Service Commission*, 360 U.S. 378, 388). And it found that "the use of liberalized depreciation results in a permanent reduction of federal income taxes by natural gas pipelines maintaining either a growing or stable plant" (31 FPC at 221). Since Alabama-Tennessee was found to be a growing company, the Commission ordered it to flow through the tax savings from its use of liberalized depreciation to its customers. And it maintained this position with respect to all other pipelines taking liberalized depreciation until the present case.

3. It is in this context that we must consider the validity of the rationale adopted by the Commission in the present case for permitting Texas Gas to shift to flow through for its existing and non-expansion property. And

it is particularly noteworthy in this respect that the Commission opinions (App. 100-111, 145-149) do not, despite the Commission's reference in its brief (p. 31) to the present gas supply crisis, suggest that Texas Gas will not continue to maintain a growing or at least stable plant with respect to its pipeline operations.[18] On the contrary, it concluded (App. 110) that "while Texas Gas' pre-1970 properties may represent a declining net investment, the company will undoubtedly be adding to its entire rate base by post-1969 construction. . . ."[19]

The principal thrust of the Commission's opinion is not that Texas Gas as an ongoing entity will cease to reap tax savings from its continued use of liberalized depreciation on all of its property, but that, because it had been permitted to normalize its taxes with respect to new expansion property, its use of liberalized depreciation for its old and non-expansion property, considered in isolation from the new property, would no longer be likely to result in tax savings. As the Commission put it in Opinion 578 (App. 108-109):

> "It therefore follows that the pre-1970 tax plant will not be a stable plant in the sense that plant retirements are replaced by new facilities, but the

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[18] The Commission brief (p. 31) suggests that the gas shortage indicates that "the continued rapid expansion of the natural gas industry can no longer be taken for granted." But in *Alabama-Tennessee* it held that liberalized depreciation results in tax savings whenever a pipeline maintains a "growing or stable" plant, 31 FPC 208, 221. And it does not find to the contrary here.

[19] The evidence to date supports this prediction. The Annual Reports filed by Texas Gas with the Commission show that its gross gas utility plant account increased from $522,371,664 in December, 1969 to $583,090,599 on December 31, 1971. This is more than an 11% increase in just two years.

basis of tax depreciation *related thereto* will decline, so that there is little chance *with respect to this plant* that there will be any permanent tax savings" (emphasis added).

We show below that this analysis is faulty on its own terms. But what is of primary importance is the recognition of the fact that no justification is advanced—other than the Commission's mere assertion—for the underlying proposition that, because Texas Gas is now to be permitted to use normalization with respect to a portion of its pipeline facilities—its new expansion property—its continued use of liberalized depreciation on all of its property will cease to result in a tax savings. All that the use of normalization on its new expansion property will mean is that, to this extent, Texas Gas will be authorized to collect rates based on fictitious taxes and will accrue thereon an ever increasing amount which will be available for the payment of any tax increases should they ever eventuate. But Texas Gas' federal income taxes, including its depreciation deductions, will continue to be calculated on a company-wide basis. Thus if, as a company, it maintains a growing or stable plant—as the Commission assumed it would—there will be a consistent tax savings. The possibility of future higher taxes relating to old non-expansion property—if this part of the total plant does not remain stable—will continue to be offset by the lower taxes attributable to new expansion facilities. In short, all the Commission's decision comes down to is a reversion to the now discredited unit-by-unit analysis of the effect of a company's use of liberalized depreciation,

packaged in terms of the new, but equally artificial dichotomy of new versus old property.[20]

The Commission's brief confines itself to the bare statement (pp. 31-32) that "for ratemaking purposes, the benefits of liberalized depreciation on the company's expansion property are no longer available in calculating the company's tax expense on its books of account to offset the effects of declining tax depreciation on the company's books of account arising from the continued use of flow through on existing property." If this statement is intended to mean that the Commission, which elsewhere in its brief (pp. 12, 18) claims almost unlimited authority to determine the "proper" allowance to be made in a rate case for federal income taxes, in fixing the tax component of a cost of service must segregate pipeline facilities which for tax purposes the Internal Revenue Service treats as a unity, it is as amazing as it is invalid. We assume, however, that in its reply brief the Commission will fall back on the rationale used by Texas Gas below, namely that under the present language of Account 282, the new sums to be included in this account by Texas Gas, as a result of the normalization of its new expansion property, will not be available to pay any higher taxes which might be associated with old non-expansion property.

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[20] We do not have a situation presented here, as in the consolidated tax situation presented in this Court's opinion in the *United Gas Pipe Line Company* case, *supra*, where issues as to the proper allocation of tax savings among various elements of the system are required. All of the tax savings from the use of liberalized depreciation with normalization on new property will accrue to Texas Gas, and this will become an increasing amount of the total savings as new plant gradually becomes a higher percentage of total plant.

Any such argument is specious. In the first place it assumes that there will be increased taxes, despite Texas Gas' continuation to utilize depreciation on all its property and the Commission's conclusion (App. 110) that Texas Gas as a whole will maintain a growing or stable plant. Secondly, it ignores the $12,993,624 already in Texas Gas' Account 282, as of December 31, 1969, all of which is available for use in the unlikely event Texas Gas' taxes subsequently are increased as a result of its use of liberalized depreciation.[21] And finally even if the present language of Account 282 (18 CFR 201 § 282, set forth as Appendix B to this brief) can be construed as authorizing a charge to the account only with respect to property with respect to which the company previously normalized the effect of its use of liberalized depreciation—and this seems a very narrow reading of the language of the account[22]—there is nothing, except its unwillingness, to prevent the Commission from modifying the language of the account, or establishing additional accounts, to give appropriate consideration to the new situation caused by the bifurcation of depreciation treatment of pipeline property which Congress clearly

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[21] This fund was created during the period prior to 1966 when Texas Gas was permitted to normalize under the earlier erroneous views of the Commission on the matter.

[22] Paragraph B of Account 282 states that the account "shall be credited" by the amount in any year "taxes on income payable for the year are greater because of the use in prior years of liberalized depreciation for income tax purposes, and deferral of taxes in such prior years. . . ." This does not limit the prior deferral to any specified item of property. And in any event there is nothing in the language of the Account to indicate that the Commission could not or would not *permit* its utilization in other appropriate circumstances.

intended in the Tax Reform Act of 1969. Accounting is only the Commission's master if it is allowed to be.

Moreover, even if it were proper to segregate for special consideration the old non-expansion property of the pipeline, the Commission's calculations as to the long range tax effects thereof are lacking in merit. The Commission's stated reason for its view that the lower taxes on replacement or other non-expansion property would be inadequate to offset the increased taxes on old property was that the tax lives of various types of pipeline property are substantially less than their physical life. Thus it concluded that it was unlikely that replacements would be of a sufficient magnitude to offset the increased taxes due to the use of liberalized depreciation on Texas Gas' existing property in earlier years (App. 108-109). In its brief it attempts to support this conclusion with extra-record figures showing that Texas Gas' average plant retirements for the period 1965-1969, valued at cost, were only $2.7 million per year. This amount, the Commission asserts, if replaced by new facilities at the same cost[23] would be inadequate to match the annual increase in tax obligations on its old non-expansion property. The Commission, on the basis of

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[23] The Commission suggests in its brief (p. 33, n. 13) (but not its opinion) that the obviously greater cost of replacing facilities today as contrasted with their original cost should be ignored because Texas Gas has chosen to utilize an optional formula provided by the Internal Revenue Service's Regulations under which the maximum amount of investment to be classified as replacement property in any year is an amount equal to its plant retirements in that year. Assuming such calculations are appropriate for tax purposes, there is no basis for assuming that Texas Gas, by voluntarily availing itself of this tax option, can bind the Commission in its exercise of its regulatory powers.

record testimony obviously relating to a different matter (App. 17), indicates that this annual increase in tax obligations as the result of the use of liberalized depreciation on Texas Gas' existing plant amounted to approximately $33,000,000 for the year 1971 alone.[24] Since the total federal income tax obligation for Texas Gas' gas utility operations in 1970 was only $25,666,000 (*Statistics of Interstate Natural Gas Pipeline Companies 1970*, FPC 1971, p. 118), the magnitude of the probable error in this figure is clear. But aside from this error—which is perhaps inevitable in view of the fact that the hearing in the case was not concerned with any proposed move to normalization (see p. 7, *supra*)—there is no basis for assuming that the $2.7 million average is representative of the future period. On the contrary, exactly because the physical life of major plant items like pipe are long ones it is to be expected that average system retirements would have been substantially less during the first twenty to thirty years of Texas Gas' operational life than they will be in the future.

There is, moreover, an additional fallacy in the Commission's position. For if it is correct in its view that the old non-expansion property should be looked at in isolation in determining the effect of the use of liberalized depreciation then it must also be looked at by itself in determinating the total tax obligation due the federal government. But when this is done it becomes apparent that the total tax obligation with respect to this part of

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[24] Actually the $33,000,000 testified to by the Texas Gas witness appears to be the amount of new plant the pipeline would have to put into operation to compensate for the $1,100,000 *total* reduction in its plant accounts due to the taking of depreciation on such plant at an annual effective rate of 3%.

Texas Gas plant will continue to decline (see Exhibit 21, App. 42). This fact is recognized by the Commission in its Opinion, but brushed aside with the statement that "in our opinion, the effect of the declining rate base should not be used to offset the effects of liberalized depreciation with flow-through. Where there is no new investment the rate base declines in any case regardless of the method of tax depreciation" (App. 110).

Of course, the point is that if the overall tax obligation goes down faster than any one component thereof arguably increases, the danger that the pipeline's future customers will have to pay higher rates to make the company whole for federal higher tax obligations disappears. Assuming that present rate payers might properly be charged higher rates now to offset necessary or probable increased rates in the future, it does not follow that they can or should be charged higher rates now in the hopes that at some future date lower tax charges might therefore be even further reduced. In this respect it is important to note that the immediate payment of lower taxes as a result of the use of liberalized depreciation does not carry with it any obligation to pay higher taxes in the future. What the amount and rate of such future tax obligation will be depends upon the law as of that date and the profitability of the pipeline. If the worst fears of the pessimists as to pipeline prospects in future decades materialize—and there is no reason to believe they will[25]—then the present use of liberalized depreciation will not require any tax payment out of line with any possible reduction in net pipeline income.

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[25] See footnote 19, *supra*.

4. While both the Commission's opinion and its brief mention several other alleged benefits of its action permitting Texas Gas to move to normalization with respect to its old, non-expansion property, we do not read either as asserting that these factors would independently justify a switch to normalization if, contrary to its basic conclusion, the use of liberalized depreciation continued to constitute a tax savings. See App. 109. In any event, any such conclusion would clearly be improper.

The three denominated extra benefits of the Commission's action are an alleged greater stability in rates, the improvement of the companies before tax coverage of interest and the alleviation of present day cash shortages. The first of these is directly tied into the Commission's artificial bifurcation of Texas Gas' plant. Obviously an immediate $4,400,000 increase in Texas Gas' rates only breeds rate stability if it is assumed that the alternative is a higher increase at a later date, an assumption which in turn depends both on the tax deferral concept and the asserted irrelevancy of the declining rate base discussed above.

The other two "benefits" are from the viewpoint of the company's stockholders more concrete. If it is proper for the Commission to charge Texas Gas' ratepayers $4,400,000, over and beyond its actual cost of service including a fair return on its invested capital, so that the company will have the benefit of approximately half of this sum,[26] then of course the company will be better off than it otherwise would have been, even if it is not permitted to transfer the value of these additional sums

[26] The other half will be taxed as pipeline income. See text at 44-45.

to retained earnings or to pay them out by way of dividends. But unless we are talking in the context of a demonstrable tax deferral, what is involved is merely a forced consumer contribution to pipeline capital which, for purely cosmetic reasons, is being labeled as tax related.

As we have previously pointed out (pp. 30-32) the courts, in the *United, El Paso* and *Alabama-Tennessee* cases, *supra*, among others, have repeatedly stated that the Natural Gas Act's regulatory goals do not contemplate that rates will be set "to afford a just and reasonable rate plus an amount representing a savings in taxes granted the gas industry."[27] The fact that the extra sum may not itself be immediately available for transfer to retained earnings or for payment of dividends[28] does not change the basic situation. Nor should it be assumed that because the Commission now[29] follows the practice of deducting the amounts placed into the special reserve account 282 from the pipeline's rate base, the operation is without cost to the rate payer. On the contrary, of the $4,400,000 per year extra he is here being asked to contribute to Texas Gas, approximately half goes to the federal government by way of taxes (since the Internal Revenue Service looks on the extra revenues as pipeline

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[27] *El Paso Natural Gas Co. v. Federal Power Commission, supra,* 281 F.2d at 572.

[28] The Commission has in at least one recent case permitted dispersion of the account without any benefit to the rate payers, *Tennessee Gas Transmission Co.*, 44 FPC 70, 729. Even if the reserve account is maintained, its presence may make it easier for the pipeline to pay out larger amounts of its unrestricted surplus in dividends.

[29] The Commission during previous periods in which it permitted normalization, allowed pipelines to earn a return on the reserve fund. See *Northern National Gas Co., supra.*

income) and the consumer "savings" from the remainder as a result of its deduction from rate base would, at an 8% rate of return, amount to only about $350,000. In short, it costs consumers about $4,150,000 per year to give Texas Gas an interest-free loan of approximately $2,200,000.

Moreover, assuming there might be circumstances in which it would be appropriate for the Commission to fix a pipeline's rates on a basis which, in addition to the other cost-of-service components, would require its consumers to contribute additional sums to a restricted reserve to be deducted from the pipeline's rate base, the present case is not even arguably a proper occasion for initiating such action. If there were demonstrable grounds for requiring gas consumers to contribute capital for pipeline expansion, the pipeline's needs in this respect would hardly be measured by the extent of the tax savings resulting from its use of liberalized depreciation and the Commission has not suggested that it is. More important, it is clear that any of the need for such consumer-contributed capital could only be evaluated as part of the determination of the pipeline's overall cost-of-service and particularly its appropriate return.

This, however, is exactly what the Commission refused to do with respect to Texas Gas. In recognition of the close relationship between the two issues, the tax treatment to be afforded Texas Gas and the appropriate rate of return it should be allowed had been set down by the Examiner for separate initial consideration as Part I of the rate proceeding (App. 81-82). A hearing on the two issues was completed and the record therein certified to the Commission for decision pursuant to its Order of December 23, 1969 (App. 82). But the Commission took

no action to decide the rate of return issue on its merits. Instead, on June 3, 1970 it issued its Opinion 578 which, pursuant to the request of Texas Gas for "Expedited Decision on Limited Issue" (App. 90-94), concerned only the tax issue.

Shortly thereafter Texas Gas filed a settlement agreement, to which New York was not a party, which proposed a settlement of all of the other issues in the proceeding including rate of return (App. 112). New York objected to approval of the settlement in view of the interrelationship between the tax issue just resolved in Opinion 578 and the 8% rate of return which underlay the settlement cost-of-service, pointing out that the Commission had indicated that its tax decision would, *inter alia*, serve to improve Texas Gas' before tax coverage of interest and cash flow position (App. 123-125). New York also raised this interrelationship between the two issues in its petition for rehearing of Opinion 578 (App. 126-127). But the Commission brushed aside the contention in its order approving the settlement on grounds that any extra amounts included in Texas Gas' cost-of-service due to the use of normalization "do not represent additional return to Texas Gas" (App. 143), and repeated this litany in denying rehearing of Opinion 578 (App. 147).

This, of course, merely ducks the issue which New York was raising. For, whether or not the extra allowance is properly classifiable as "additional return" or, as New York actually characterized it (App. 124), as additional income which "bears many of the attributes of return," any justification of tax normalization on grounds of improvement in the pipelines before tax coverage of interest or its cash flow situation cannot be evaluated

separately from the consideration of the pipeline's proper rate of return. However, as a result of the peculiar procedures followed by the Commission here, no effort was made by the Commission to consider the obvious interrelationship of the two issues. Instead the tax issue was decided first, before any consideration had been given by the Commission to Texas Gas' appropriate rate of return and without any consideration of Texas Gas' actual needs for cash or greater interest coverage. Under these circumstances the Commission simply had no basis for any conclusion that any additional rate allowance was required by Texas Gas for such purposes, even assuming that such additional allowances might otherwise be proper.

Accordingly, should this Court conclude that the court of appeals' determination that Congress precluded any shift from flow through to normalization on the pre-1970 or non-expansion property of a pipeline was in error, and proceed to resolve the issues not decided below, it can only find that the Commission's stated bases for its action here were without factual and legal support and inconsistent with the regulatory objectives of the Natural Gas Act.

CONCLUSION

For the reasons set forth in Part I of this brief the decision of the court below should be affirmed. If, however, this court does not so conclude, then it should determine, for the reasons set forth in Part II, that the

Commission's action was invalid and remand the case to the court of appeals with instructions to set aside the Commission's order and remand the case for appropriate further action.

Respectfully submitted,

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APPENDIX A

SECTION 441 OF THE TAX REFORM ACT OF 1969, AS PASSED BY SENATE

SUBTITLE E—DEPRECIATION ALLOWED REGULATED INDUSTRIES; EARNINGS AND PROFITS ADJUSTMENT FOR DEPRECIATION

SEC. 441. PUBLIC UTILITY PROPERTY.

(a) In General.—*Section 167 (relating to depreciation) is amended by inserting after subsection (k) (added by section 521) the following new subsection:*

"*(l)* Reasonable Allowance in Case of Property of Certain Utilities.—

"*(1)* Pre-1970 Public Utility Property.—

"*(A)* In General.—*In the case of any pre-1970 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—*

"*(i) a subsection (l) method, or*

"*(ii) the applicable 1968 method for such property.*

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

"*(B)* Flow-Through Method of Accounting in Certain Cases.—*In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—*

"*(i) the taxpayer used a flow-through* [343] *method of accounting for such property for its July 1969 accounting period, or*

'(ii) the first accounting period with respect to such property was after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

'(2) Post-1969 Public Utility Property.*—In the case of any post-1969 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—*

'(A) a subsection (l) method,

'(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

'(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

'(3) Definitions.*—For purposes of this subsection—*

[344] *'(A)* Public Utility Property.*—The term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—*

'(i) electrical energy, water, or sewage disposal services,

'(ii) gas or steam through a local distribution system,

'(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized

by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

"(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

"(B) Pre-1970 Public Utility Property.—*The term 'pre-1970 public utility property' means property which was public utility property in the* [345] *hands of any person at any time before January 1, 1970.*

"(C) Post-1969 Public Utility Property.—*The term 'post-1969 public utility property' means any public utility property which is not pre-1970 public utility property.*

"(D) Applicable 1968 Method.—*The term applicable 1968 method means, with respect to any public utility property—*

"(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969.

"(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

'(iii) if neither clause (i) nor (ii) applies, a subsection (l) method.

In the case of any action 1250 property to which subsection (j) applies, the term 'applicable 1968 [346] *method' means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.*

'(E) Applicable 1968 Method in Certain Cases.—*If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (l) method) with respect to any public utility property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.*

'(F) Subsection (l) Method.—*The term 'subsection (l) method' means any method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable* [347] *solely by reason of the application of subsection (b)(4) or (j)(1)(C).*

'(G) Normalization Method of Accounting.—*In order to use a normalization method of accounting with respect to any public utility property—*

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

"(H) Flow-Through Method of Accounting.—*The taxpayer used a 'flow-through method of accounting' with respect to any public utility property if it used the same method of depreciation to compute its allowance for depreciation under this section and to compute its tax expense for purposes* [348] *of reflecting operating results in its regulated books of account.*

"(I) July 1969 Accounting Period.—*The term 'July 1969 accounting period' means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expense for purposes of reflecting operating results in its regulated books of account.*

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

"(4) Special Rules as to Flow-Through Method.—*For purposes of determining whether or not a taxpayer used a flow-through method of accounting for its July 1969 accounting period with respect to any property—*

"(A) In applying paragraph (1)(B) or (2)(C) for taxable years beginning after December 31, 1970, the taxpayer shall be deemed not to have used such method if it has so elected within 180 days after the date of the enactment of this subsection in the manner prescribed by the Secretary or his delegate.

"(B) In applying paragraph (1)(B) or (2)(C), the taxpayer shall be deemed to have used such method if it adopts such flow-through method [349] *in compliance with a change authorized within 90 days after the date of the enactment of this subsection by the appropriate State regulatory commission pursuant to proceedings instituted by such commission before April 22, 1969, during which the taxpayer proposed before April 22, 1969, to make a rate reduction conditioned upon and effective immediately after authorization by such commission of the flow-through method of accounting for the taxpayer.*

"(C) In applying paragraph (1)(B), the taxpayer shall be deemed to have used such method with respect to any public utility property for which it filed a timely application for change of accounting method before August 1, 1969, if with respect to public utility property of the same (or similar) kind most recently placed in service, it used a flow-through method of accounting for its July 1969 accounting period.

"(5) Reorganizations, Assets, Acquisitions, etc.*—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to rate-making by more than one body, or by reason of other circum-*[350]*stances, the application of any provisions of this subsection to any*

public utility property does not carry out the purposes of this subsection, the Secretary or his delegate shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection."

APPENDIX B

EXTRACT FROM THE FEDERAL POWER COMMISSION'S UNIFORM SYSTEM OF ACCOUNTS PRESCRIBED FOR NATURAL GAS COMPANIES, 18 CFR 201

282 Accumulated deferred income taxes–Liberalized depreciation.

A. This account shall be credited and account 410, Provision for Deferred Income Taxes, shall be debited with an amount equal to that by which taxes on income payable for the year are lower because of the use of liberalized depreciation in computing such taxes, as permitted by Section 167 of the Internal Revenue Code of 1954, as compared to the depreciation deduction otherwise appropriate and allowable for tax purposes for similar property of the same estimated useful life according to the straight line or other nonliberalized method of depreciation.

B. This account shall be debited and account 411, Income Taxes Deferred in Prior Years–Credit, shall be credited with an amount equal to that by which taxes on income payable for the year are greater because of the use in prior years of liberalized depreciation for income tax purposes, and deferral of taxes in such prior years as described in paragraph A above. Such debit to this account and credit to account 411, shall, in general, represent the effect on taxes payable for the current year of the smaller amount of depreciation permitted for tax purposes for the current year with respect to any depreciable property for which liberalized depreciation was used in prior years, as compared to the depreciation deduction otherwise appropriate and available for similar property of the same estimated useful life according to

the straight line or other nonliberalized depreciation method ordinarily used by the utility in computing depreciation for tax purposes.

C. Records with respect to entries to this account, as described above, and account balance, shall be so maintained as to show the factors of calculation and the separate amounts applicable to the plant additions of each vintage year for each class, group, or unit as to which different liberalized depreciation methods and estimated useful lives have been used. The underlying calculations to segregate and associate deferred tax amounts with the respective vintage years may be based on reasonable methods of approximation, if necessary, consistently applied.

D. The use of this account and the accounting described above are not mandatory for any utility, which in accordance with a consistent policy, elects not to follow deferred tax accounting even though liberalized depreciation is used in computing taxes on income. If, however, deferred tax accounting is initiated with respect to any property, such accounting shall not be discontinued on that property without approval of the Commision.

E. The utility is restricted in its use of this account to the purposes set forth above. It shall not transfer the balance in the account or any portion thereof to retained earnings or make any use thereof except as provided in the text of this account without prior approval of the Commission. Any remaining deferred tax reserve balance with respect to any year's plant additions or subdivisions thereof for which liberalized depreciation accounting has been followed or, upon retirement from service of such property or predominant portion thereof, or upon

expiration of the estimated useful life on which the depreciation calculations for tax purposes are based, shall be credited to account 411, Income Taxes Deferred in Prior Years–Credit, or otherwise applied as the Commission may authorize or direct.